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The Enron bankruptcy is the largest in US history, and its repercussions will go on for years. How much will the Enron mess affect the stock market and the way corporate earnings are reported? I really don't know, but I would have to guess that there will be huge repercussions. With "operating" earnings, "pro forma earnings", current earnings, trailing earnings — nobody today knows what the devil the corporations are talking about. The fact is that corporations can literally announce any earnings they want, thus the famous "one cent better than expectations" has become an almost mindless addition to Wall Street-speak.

Richard Russell, *Dow Theory Letters*, Jan. 24, 2002

ILLUSION OR HOAX?

The American economy is being widely hailed for stepping along the road to recovery after the mildest recession in the past half-century. Better still, a recorded productivity gain of 3.5%, annualized, for the fourth quarter is generally acclaimed as proof that the productivity miracle, the key hallmark of the "New Economy," remains alive and well. The comforting explanation of the recession's unusual briefness and shallowness is that corporations have been unusually quick to cut excesses and costs. This, it is argued, promises fatter profits in the upturn — and therefore justifies today's lofty share prices. Equity analysts, on average, forecast a 37% rise in the profits of companies in the S&P 500 index to the fourth quarter of 2002.

The easiness with which American economists turn everything black into glaring white in assessing the U.S. economy keeps amazing us. Despite overwhelming evidence, it took them a long time to concede the possibility of a recession. Now they see the economy's immediate recovery in every statistical blip. Everybody simply grabs at the most flimsy data as conclusive evidence a recovery is starting. It's a discussion that lacks any intellectual depth.

Whatever some economic data and indicators may say, the essential conditions for a sustainable recovery simply do not exist. Yet unbelievable complacency still rules. Irrespective of overwhelming evidence to the contrary, "new paradigm" optimism remains largely intact, as does blind faith in Alan Greenspan and the Fed. Even though profits have collapsed as never before, profit expectations and forecasts remain ridiculously high. The main problem seems to be that the consensus is at a complete loss to understand what is happening.

Every economic downturn has its origin in the economic and financial maladjustments that have accumulated during the prior boom. That is why we keep scrutinizing the last boom's pattern. It is now clear as daylight that the vaunted profit miracle was not only a mirage but an outright hoax. Taking a closer look at the equally vaunted investment boom and productivity miracle of the past few years, we identify a lot of creative GDP accounting. The fabulous "wealth" creation of the late 1990s has consisted entirely in soaring financial assets and debts. The fact is that such phantom wealth promotes speculation and capital consumption. Creation of productive wealth in tangible assets went begging.

ALMOST A CULTURE OF CORRUPTION AND FRAUD

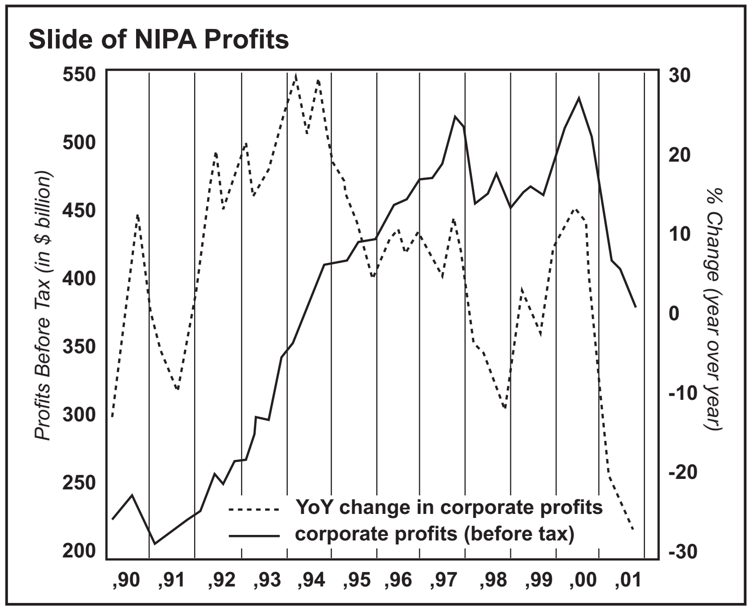
"This is almost a culture of corruption," said Senator Byron Dorgan, heading the congressional Enron hearing. To us, this seems a gross understatement. What happened at Enron was definitely a lot more than just corruption. It is the business world's single largest fraud in history. For sure, it is an extreme case of fraud. But the fact that an unprecedented number of American corporations are using ever more aggressive reporting and accounting tricks to deceive investors about their poor profit performance has been a regular topic in the media for quite a while. On May 14, 2001, *BusinessWeek* carried an extensive article titled "The Numbers Game." It

was headed by a sentence in big letters: *"Companies use every trick to pump earnings and fool investors. The latest abuse: Pro forma reporting."* So the Enron case in itself was nothing to be surprised about. It was simply too big to be shrugged off.

Executives, external directors, auditors, bankers, lawyers and market analysts all knew.

Yet their common, overriding interest was to keep the stock market booming. We, ourselves, had no inside information, of course. But we noticed years ago the vast and soaring divergence between skyrocketing S&P 500 earnings computed from the corporate profit reports and the unusually poor profit performance as reflected in the government's national income accounts. The two differed like day and night. It was manifest for years that the companies and their CEOs were using many accounting and reporting tricks to deliver the continually rising sales and earnings per share that Wall Street wanted to see.

By so-called pro forma reckoning, the companies in the S&P 500 stock index earned $45.31 per share in 2001, giving the market a price-to-earnings ratio of 24.7, according to Thomson Financial/First Call. But by using generally accepted accounting principles, earnings were just $28.31 per share in the 12 months through September, equating a P/E ratio just under 40.



Most visible to any somewhat critical observer, however, was the soaring discrepancy between the profits that the corporations reported and that went into the S&P 500 earnings, and the profits reported by the Commerce Department within its national income and product accounts. In particular since 1997, there could be no doubt anymore that the corporate numbers were just trash. Yet even the Commerce Department figures were heavily inflated for years by capital gains in the stock market.

When the capital gains vaporized with the skidding stock market in 2000, American corporations had to rely on profits truly earned in production for the first time in many years. Not surprisingly, this stepped up pressure on desperate CEOs to somehow shore up earnings. Resorting to more and more aggressive accounting tricks was one of the ways. But in the face of rapidly worsening profits, these tricks essentially had their limits. It needed ever more and ever bigger ploys to mislead unwary investors.

The answer was to top crooked corporate accounting with even more crooked profit reporting. EBITDA earnings — earnings before interest, taxes, depreciation and amortization — commonly also called "operating earnings," became common practice even for blue-chip firms. "Pro forma" profits are the evil cousin of operating earnings. The particular attraction of this profit formula is that it literally allows a company to omit any expenses it cares to choose and to report any profit it wants. No less evil in essence is the new practice to no longer compare reported profits with objective, past earnings but with arbitrarily slashed expected profits. All these gimmicks are really so primitive that they offend common sense and probity. But both are clearly absent in today's world of finance. Complete obfuscation and chaos is the new reality in corporate profit reporting in the United States. Virtually ignored in the same vein is the simultaneous escalation in the number and size of corporate bankruptcies.

THE STARTER: OVER-HYPED EXPECTATIONS

Such gross and widespread dishonesty in the world of business and finance has no precedent in history,

neither in America nor in the rest of the world. Why? What is it that led to this culture of corporate corruption and fraud? Our short answer is: It started with over-hyped expectations that deluded corporate management into strategies that impaired economic growth and profitability in the longer run. The manifest chief cause of this accounting crisis is a profits crisis. The decisive fact is that the corporations have been unable to deliver the lofty profits that they had promised and that everybody had come to expect from them. Actually, their profit performance not only disappointed the over-hyped expectations, it has been the worst profit performance in the whole postwar period. Instead of maximizing profits, the new corporate strategies minimized them. It was America's first profitless boom.

It started with surprisingly good news about the U.S. economy from 1995 on, following several years of sub par economic growth. All of a sudden it was as if the economy had transformed itself into an entirely different economy. Real GDP growth and productivity took off at rates that had not been seen for decades, while inflation and unemployment fell. Essentially, this provoked questions about the underlying causes.

In no time there was talk of a "new paradigm" economy performing virtual miracles of efficiency and profitability. There was quick agreement that this primarily owed to the dazzling wonders of the new information technology. Many hailed it as the biggest leap forward since the Industrial Revolution, if not even a bigger revolution. Double-digit corporate earnings growth was no longer regarded an exceptional achievement. It became a general mandate, a benchmark of normality for years to come, being presented as an integral part of the new shareholder-value culture. Stock valuations took off to unprecedented levels.

There were other, more arcane claims supposedly justifying the new sky-high P/E ratios for stocks. Mr. Greenspan meditated in public that the exponential gains in the speed of information, thanks to the new technology, had created an unprecedented low-risk, high-certainty economy that had made the traditional risk premium on stock prices obsolete. Other than Mr. Greenspan, the most prominent advocates of that view were James Glassman and Kevin Hassett, authors of the book *Dow 36,000*.

Last but not least, it became a big argument, also frequently advanced by Mr. Greenspan, that the low inflation rates, supposedly resulting from the productivity-enhancing high-tech capital spending, allowed the Fed to underpin economic growth with a looser monetary policy than in the past. In a congressional testimony on June 10, 1998, he said: *"The essential precondition for the emergence and persistence of the virtuous circle is arguably the decline on the rate of inflation to near price stability — which, in turn, provides the preconditions for a stock market boom."*

Yet this tale of economic high-tech wonders had an important supplementary chapter. It concerns corporate governance and said that the U.S. economy has also immensely benefited from a quantum jump in the quality of corporate management, owing to the triumphant progress of the shareholder-value movement. Starting out with the postulate that companies have ultimately one single boss, that is, the shareholder, it led to the emphatic conclusion that corporate management ought to, therefore, concentrate its energies single-mindedly on aiming to maximize shareholder value through aggressive profit creation. In order to entrench the rigorous pursuit of this goal in the mind of executives, it was recommended that they establish a strong joint interest between themselves and their shareholders through the wide introduction of share option schemes keyed to sales and profits.

ADDICTION TO UNATTAINABLE PROFIT FORECASTS

What actually happened was that corporations and investors simply became addicted to ridiculous, unattainable profit forecasts and expectations, and by no means only in the high-tech sector. It spread across the corporate landscape to the firms of the Old Economy, all of them desperate for the valuable Wall Street emblem of "growth stock," qualifying them for sky-high market valuation. If homegrown double-digit profit growth was impossible, it could always be bought through mergers and acquisitions. What followed was really foreseeable: Exposed to relentless pressures to deliver the impossible, more and more CEOs resorted to increasingly aggressive creative accounting and profit reporting.

So much for the assumptions and assertions behind the heady rise of U.S. stock prices. Manifestly, they convinced numerous people. Share prices escalated against a backdrop of pervasive confidence in the wonders that would derive from the revolutions in high tech and new corporate governance, both being eminently supported by excellent monetary and fiscal policy. It wasn't only Americans who believed in the superiority of the U.S. economy and its financial system. Carried away by their admiration, foreign, particularly European, corporations, banks and investors poured trillions of dollars into the United States, hoping to profit from the unfolding miracles.

TWO BADLY FLAWED PERCEPTIONS

As to the productivity miracle, it started with a bang. A sudden, abrupt jump by 2.8% in 1996 followed three years during which productivity growth had averaged 0.65%. This abruptness struck us as rather strange. Major secular changes in productivity growth are not prone to happen overnight.

Above all, however, we regard the popular arguments behind the euphoric profit predictions as badly flawed right from the beginning. In line with traditional thinking in economics, we regard investment in the shape of capital goods as the one and only key to genuine prosperity, both now and in future. The innovations of the Industrial Revolution created such immense prosperity because their application embodied vast capital investments. In contrast, the new information technology is destined to remain profitless because it involves so little capital investment. What matters is not the innovation as such but the associated capital formation. For very much the same reason, we had come to a highly negative assessment of America's new shareholder-value model. In their frantic pursuit of quick profit and shareholder-value maximization, deal making and cost cutting had become trumps over new capital investment. From the macroeconomic perspective, this was not profit-enhancing but profit-diminishing.

Early warnings of the dire failure of the new corporate strategies to improve aggregate profits came from the Commerce Department's NIPA accounts. They showed that corporate profit growth in the nonfinancial sector had effectively peaked as early as 1994. Returns stagnated throughout 1997 to 2000. With an amount of $504.5 billion before tax, these profits had accounted for 7.6% of national income in 1997. Until 2000, this ratio had fallen to 6.2%. Most shockingly, this decline in profit margins had happened while the economy was still booming. By the third quarter of 2001, the profits of nonfinancial firms as a share of national income were down to 4.7% of national income. While everybody is calling it the mildest recession of the past half-century, for corporations it is already the worst profit recession. And there is no letup in sight.

Putting it bluntly: The trumpeted "profit miracle" of the New Economy was a mirage. In our view, it was a hoax in which the whole system participated: corporate management, auditors, market analysts and the media. Failure of the predicated profit miracle to materialize led to using every dirty accounting device at their disposal to boost reported profits and equity value.

WHAT WENT WRONG WITH PROFITS?

All this begs the all-important question: What went wrong with U.S. corporate profits? Putting the answer in a nutshell: the earlier, exuberant assumptions about profit wonders from the new information technology and the new corporate shareholder-value governance were badly flawed, and that is not just a temporary ill fortune. Low profitability is basic to both of them.

The popular explanation of the profit misery is a lack of pricing power owing to fierce global competition and low inflation. It is one among several reasons, but not the most important one. Corporate earnings are the difference between total current revenues and total current expenses. But this view overlooks that business revenues consist of two different main streams. One is what the public spends on consumption; and the other one is what businesses spend on capital investment. These two streams added together make up the receipts of the entrepreneurs.

The most important profit source in a capitalist economy is not consumer spending but the investment

spending of the entrepreneurs themselves. To be precise, it is net fixed investment, and that is because this kind of spending creates business receipts without generating an immediate expense. When a firm purchases a building or a machine, no expense is incurred until the first depreciation is recorded. The producer and seller of the building or the machinery, however, have an increase in current revenues.

From a macroeconomic perspective, the crucial point to see now is that net investment spending increases overall business revenues without a simultaneous increase in expenses.

The consumer, in contrast, is normally a big negative influence on aggregate business profits. This has its basic reason in the fact that ultimately all incomes — salaries, wages, rent, interest — come from current production, more precisely, from the business sector's costs of production. For business profits, it is now decisive how much of these costs return via consumer spending as business revenues. To the extent that consumers save or buy foreign goods, business revenues and profits decline.

Apparently, this approach of assessing profits and profit prospects through this macroeconomic equation focusing on the flows of funds within the economy that contribute to profits, subtract from profits or have no effect at all has fallen into complete oblivion. It was first developed by Keynesians, leading at the time to the famous proposition that workers spend what they earn while businesses earn what they spend. In the United States, it is extensively practiced by the Levy Institute in Mt. Kisco, New York.

In our view, this macroeconomic profit equation is indispensable in judging profits and their prospects. Moreover, it provides very valuable insights into profit sources. These insights, in fact, revealed to us very early on that the high-riding profit expectations from the new information technology and the shareholder-value strategies were grossly misguided. The preferred strategies, such as mergers and acquisitions, downsizing and cost cutting, clearly suffer from what the old economists used to call the fallacy of composition. What is a sensible decision for the individual company may be folly if most companies do the same.

Consider the following: As every entrepreneur knows, labor costs are in general a major component among the costs of production. For the single firm, cutting payroll expenses is a reasonable device to improve profits. Accordingly, it is commonly believed that this must also be true in the aggregate when many or most firms do the same. But there is a logical trap. From a macro perspective, labor costs become business revenue when the wage and salary earners spend their income to buy the goods and services that businesses produce with their help. In the aggregate, therefore, cutting payroll expenses means cutting consumer incomes and consumer spending, which, in turn, reduces business revenue and profits.

MERGERS AND ACQUISITIONS — A MACRO FOLLY

The most conspicuous feature of the new corporate shareholder-value culture in the United States was the frenetic merger and acquisition activity. Unquestionably, the huge corporate purchases of stocks that it involved have played a key role in propelling stock prices to their lofty heights. Moreover, it happened very fast and without great effort. Apparent wealth creation appeared to be thriving as never before. *"The Internet has created more value more quickly than any other technology we know of,"* crowed a well-known Wall Street analyst.

For sure, this deluge of deal making was an unprecedented bonanza for those directly concerned: CEOs, investment banks and shareholders, all their gains coming from the skyrocketing stock prices. Keeping Wall Street and shareholders happy was hailed as the surest road to economic growth and prosperity. In this new era, as Treasury Secretary Larry Summers put it, *"financial markets don't just oil the wheels of economic growth; they are the wheels."* The former slogan, "What is good for General Motors is good for America" was replaced by the new slogan, "What is good for Wall Street and stock prices is good for America." From this perspective, the commandment of maximizing shareholder value was a fabled success.

The customary justification for the merger and acquisition frenzy has always been that the united firms would be able to enhance productivity and competitiveness through exploiting synergies. Nobody, though, bothered to check this claim's validity; it was blindly accepted in the belief that what is good for share prices

must be good for the economy. The highly visible immediate gains in stock prices were too spectacular to invite critical assessment. With a stroke of their pen, the managers of the acquiring companies boosted their sales and their profits, and hence their own salaries and bonuses that were tied to sales and profits. Yet this caused little questioning among the public because the same stroke of the pen also enriched a growing number of shareholders.

In principle, the individual firm always has the choice between two different routes of expansion: through capital investment, that is, through building new plants and equipment; or through buying existing plants and equipment. Economic reason suggests that the decision will essentially depend on which of the ways is the cheaper one. There is no sense in building up a new enterprise when a similar one can be bought in the stock market at a lower price. Conversely, there is a strong inducement to spend on a new project if it costs less than a purchase in the stock market. The two propositions really express the simplest common sense.

But the shareholder-value-driven merger and acquisition frenzy that has raged in the past few years in the United States has effectively put common sense completely on its head. Corporations stampeded into purchases of existing firms at market valuations several times their book value or their costs of reproduction.

From a macroeconomic perspective, this was outright insanity. No less foolish and irresponsible was the developing epidemic of corporate stock buybacks at record-high stock prices and record-low yields, in particular when financed with more expensive borrowed money. Implicitly, this boiled down to a systematic ravage of balance sheets and long-term profitability as compounding debts involved compounding interest costs. From 1997-2000, the interest bill of manufacturing corporations surged by 60%. But nothing counts against quick, big gains in stock prices under the shareholder-value auspices.

THE BAD NEWS

A lot of people, clearly, made lots of money in the stock market. Popular opinion has it that the higher stock prices reflect new wealth and brilliant corporate management. Mindful that only productive investment creates lasting prosperity, our assessment focuses on four features: net fixed investment adding to the capital stock; business saving from retained earnings; profit growth; and productivity growth.

By these four key measures of economic health and strength, the U.S. economy's development in the past five to six years has been downright disastrous. The relentless imperative to inflate stock prices creates big temporary gains for some people. But the extraordinary boost to consumption implies capital consumption and impoverishment of society as a whole in the longer run.

The conspicuous negative hallmarks have been unprecedented excesses in consumer spending, as reflected in collapsing personal saving and a very low rate of net investment as its implicit counterpart. Profit margins are at their lowest in the last 50 years. Collapsing investment spending in turn induces falling consumer spending. As to resource allocation, it clearly went the wrong way in the U.S. economy. Personal consumption swelled as a share of GDP from a traditional rate of around 67% to 80%. Its visible counterparts were the soaring trade deficit and a very low rate of business net fixed investment.

Considering that gross nonresidential investment fell $134.4 billion (fourth quarter to fourth quarter) during 2001 while capital depreciation charges swelled by $69.7 billion, net fixed investment growth has essentially turned heavily negative. According to the macroeconomic profit equation, this has implicitly hammered corporate earnings.

Over the five-year period 1995-2000, net nonresidential fixed investment actually rose overall by $220.4 billion, or $44.1 billion per year. At this level, it has been America's lowest net investment ratio in the whole postwar period. Its most reasonable explanation is that the soaring merger and acquisition activity, chasing after the quickest possible profits, increasingly displaced new investment, requiring "patient" capital.

Pondering the implications of these figures, please bear two things in mind: first, that net investment, and

net investment alone, represents the creation of national wealth; and second, that it also represents the main corporate profit source.

Poor net fixed capital investment was an outstanding tarnish of the new American model of corporate governance; reckless ravage of corporate balance sheets by heaping more and more debt on less and less equity was the other one. This, too, was helpful to boost profits per share and thus also stock prices, but it could not even be pretended that it did anything positive to corporate warp and woof.

To get a broad idea of the ravage imparted to corporate balance sheets during these years, just compare the two following figures covering 1995-2000: U.S. business net fixed capital investment edged up $321 billion; indebtedness ballooned by $2,472.7 billion. For each dollar added to net new fixed investment, there were 7.7 dollars added to indebtedness. The stunning difference between the two figures essentially reflects the fact that the debt orgy went overwhelmingly into unproductive use, mainly stock buybacks, mergers and acquisitions. Counterpart to the soaring gap between debt growth and net investment growth were bits of paper bearing the pretentious title of "goodwill."

RAVAGED BALANCE SHEETS

Much too late, investors began to turn a slightly critical eye on the corporate debt escalation and the plainly mushrooming tricks in accounting and reporting to delude them about effectively poor profits. Shares of suspected firms have been clobbered. What's more, worries have spread to the corporate bond market, showing in rising credit spreads. Bad loans at big commercial banks have jumped nearly 30% to more than $25 billion, according to the Federal Deposit Insurance Corp. The multibillion-dollar commercial-paper market has drastically shrunk as short-term investors refuse to finance many firms formerly regarded as the cream of corporate America. All this is leading in one direction: tighter and costlier credit for corporations.

It is said that millions of investors are angry and disillusioned about the financial community that has so grossly defrauded them. Looking at sky-high P/E ratios, we have the impression that complacency and hope still grossly outweighs worry. Considering the vast scale of profit cheating, the reaction of the markets has been amazingly docile. Estimates from Thomson Financial/First Call, which record earnings "as the majority of analysts sees them," suggest that S&P 500 companies earned about $410 billion in 2001. But according to NIPA profits, calculated in line with GAAP, they earned only $240 billion. Even the latter, by the way, ignore write-offs from goodwill, running into trillions of dollars.

Yet the poor profits are not the only stain on America's new equity culture. A relentless ravage of balance sheets is the other one. Contrary to widespread perception, this ravage did not originate in investment excesses but in breakneck excesses of corporate leverage as management desperately tried to conceal and offset an increasingly disappointing profit performance. Amid weakening profits, accelerating stock buybacks, mergers and acquisitions necessitated a sharp rise in debt financing. In essence, it was a policy après nous le déluge because the short-term gains in profits were bought at the price of rapidly compounding interest in the long run. As the table shows, it had rather frightening financial effects in the short run.

CORPORATE FINANCE (IN $ BILLIONS)*

	1997	2000	2001 III
Profits Before Tax	496.1	504.2	381.0
Profits After Tax	337.7	317.6	241.7
Dividends	218.1	269.0	320.1
Undistributed Profits	119.6	48.6	- 78.4
Net Interest	120.0	172.1	170.6
Financing Gap**	110.3	265.5	178.6
Increase In Corporate Debt	266.5	565.2	

* Nonfinancial corporations

** capital expenditures less U.S. internal funds

Source: Commerce Department, Survey of Current Business

Manifestly, the profit miracle has failed to materialize. The big question is its underlying cause or causes.

Was it due to some external influences, or was it due to intrinsic, badly flawed corporate policies? For us, it's clearly the latter.

A BOGUS INVESTMENT BOOM

For sure, the U.S. corporate profit misery has a variety of causes. As explained earlier, business net fixed investment is typically the single most important profit source. High-investment economies are, as a rule, high-profit economies. The one conditions the other. Low and falling net investment happens to be the decisive, big negative in the U.S. macroeconomic profit equation. According to popular perception, business fixed investment in the past few years has overshot substantially, leading to excessive capacity growth across the whole economy, though particularly in high-tech. In this view, the economy's present downturn mainly reflects the bust of this investment boom.

It's another flagrant misjudgment of the economic situation in the United States. The great bubble excess was in consumer spending, while business fixed investment has been anemic. The apparent sharp pickup in business investment spending has two main sources: accelerating depreciation charges due to a pronounced shift in the pattern of investment from traditional longer-lived machinery towards very short-lived assets, such as computers and software; and the way American number crunchers measure computer investment.

Looking for profit and capacity effects, we focus on business net fixed investment in current dollars. It grew, as already mentioned, by $220.4 billion between 1995-2000, accounting for 8.9% of nominal GDP growth. The impression of a roaring investment boom arises from the growth of gross investment, measured in real terms. It amounted over the same period to $468 billion and accounted for 28% of real GDP growth.

But this surge in gross capital investment is heavily correlated with accelerating depreciation charges, owing to increasingly short-lived investments. What matters, however, for profit and capacity growth is net fixed investment. Subtracting the growing part of investment that merely replaces aging capital stock leaves a level of net investment in the United States during these years well below the average of the postwar period. With the preponderance of short-lived investments, it now takes about 2.2 dollars of gross capital investment to yield 1 dollar of net addition to capital stock in the United States. Still more curious is the fact that adding the depreciation charge to GDP growth adds equally to productivity growth.

The single biggest and strangest distortion in the U.S. GDP figures comes, however, from the peculiar treatment of computer investment through a measurement technique called "hedonic" pricing. Its essence is to capture increases in "real" computer power. By translating these into price declines, it adds correspondingly to "real" GDP growth. Though introduced in the late 1980s, it has worked statistical wonders of economic growth since 1995, as technological improvements apparently escalated.

To give an idea of its impact: Between 1995-2001, actual business spending on computers increased just $23.2 billion, from $64.6 billion to $87.8 billion. Stretched over six years, it was a trivial amount for a $10 trillion economy. But the "hedonic" deflator magnified this into a 10 times bigger jump of $240 billion, from $49.2 billion to $289.2 billion. And bear in mind: What adds to real GDP growth adds equally to productivity growth.

The same, though smaller, effect accrued from another statistical change. It was the decision to no longer count firms' spending on software in the GDP accounts as expense but as capital investment. Between 1995-2001, this stroke of the pen bettered real GDP growth by another $110 billion, adding correspondingly to productivity growth.

Overall, gross nonresidential investment rose $573 billion during these six years, accounting for close to one-third of real GDP growth. In detail, we identified the following components: $216 billion came from the hedonic deflator, $110 billion from capitalized software and $270 billion from depreciation charges. Together, the three amounted to $596 billion, a little more than total gross investment growth.

Weighing these figures, remember our earlier remark concerning the macroeconomic profit equation that net fixed investment is typically the largest and most important source of business profits. In essence, the above figures go a long way to explain the U.S. economy's extremely poor profit performance during the past several years. First: net fixed investment has been very low, and second, it was almost completely in fictitious "hedonic" dollars that nobody spends and nobody earns.

THE TRUE CAUSE OF THE BUST: POOR PROFITS

In light of these figures, we can only emphasize our persistent judgment: There was no investment boom in the United States. Like so many other false emblems of the New Economy, it was wishful thinking, helped by creative GDP and investment statistics. As an aside, countries building excessive production capacities are not prone to run a soaring trade deficit. That typically happens to overconsuming countries.

But what other than a prior investment boom can possibly explain the present investment bust in the United States? Clearly it was not caused by tight money and credit. Starting in early 2001, business investment spending apparently began to fall under its own weight. Yet even that needs a cause. Actually, there was a striking coincidence: collapsing business profits. From 2000 and to first quarter 2001, NIPA before-tax profits of firms in the nonfinancial sector plunged from $514.2 billion to $413.5 billion, both annualized.

Against the earlier exuberant profit expectations, this was a profits slaughter. What's more, it occurred after actual returns had stagnated throughout 1997 to 2000, while the economy's boom reached its apex. Finally realizing that their high-riding profit expectations were grossly failing, businesses pulled the brakes. But the all-important thing to see is that the poor profitability of U.S. corporations started at the height of the boom. To ascribe it to the terrorist attacks of Sept. 11 is complete nonsense.

NO CHANCE FOR RECOVERY

Sliding profits have been the key force behind the U.S economy's sudden, sharp downturn.

Prospects of improving profits are the key condition for the economy's recovery. *BusinessWeek* reported that the profits of 900 companies plunged in the fourth quarter by 59% from a year earlier, mentioning that it was the steepest decline since this profit compilation began in 1973, far outpacing the previous worst annual drop of 19% in recession-wracked 1991.

Recent data, above all the report of a 0.2% increase in real GDP during the fourth quarter 2001, have caused general excitement. Being considerably better than the expected decline of 1%, also annualized, it was enough to arouse jubilation. For most economists, this was the end of America's mildest recession in the whole postwar period. We noticed little or no effort among economists to take a closer look at the data.

We did. What we discovered was an ominous composition of economic growth. Comparing negatives and positives, it was a compelling conclusion for us that, fundamentally, the U.S. economy had not improved but rather deteriorated. Some special factors had kindly masked the accelerating downtrend of the private sector. Accordingly, the prospect of a GDP rebound in 2002 has receded.

What mainly and plainly makes for confusion is the fact that the great majority of economists focus excessively on trivial symptoms and surveys while completely neglecting the two crucial negative key features in the economy that ultimately condition the economy's growth or decline. These two decisive drags are *business profits* and *fixed capital investment*.

What was behind the paltry upturn, amounting to an annualized $5.2 billion? The main item was government spending, in particular at the state and local level. It soared by $36.1 billion and contributed 1.59 percentage points to real GDP growth. The other main contributor was business spending on computers. As price declines of IT equipment accelerated, the hedonic deflator worked another wonder. Measured in current dollars, spending on computers increased a paltry $1.9 billion. But hedonic treatment turned this trivial amount

into a capital-spending boost of $23.5 billion. Had it not been for government spending and the hedonic deflator, U.S. real GDP growth would have been down in the fourth quarter at an annual rate of more than $50 billion, or more than 2% — far worse than expected.

Closer to the ugly truth comes the Commerce Department's GDP calculation in current dollars. By this measure, economic growth sharply weakened from positive 0.9% in the third quarter to –0.1% in the fourth quarter.

What was so particularly negative about the fourth quarter? In short, the accelerating decline in profits and business fixed investment. Even Mr. Greenspan has meanwhile admitted that their improvement is critical for a sustainable recovery. But just the opposite has happened in the fourth quarter, and what's more, there is nothing in sight that could reverse this dismal trend.

Even with the hedonic boost, the plunge of business fixed investment has steepened, shaving 1.92 percentage points from real GDP growth in the fourth quarter, after 1.08 percentage points in the prior quarter. Housing, by the way, has also turned into a small negative contributor in real terms. The annualized rates of decline were 14% for business fixed investment, 15% for exports but only 0.6% for imports.

Still, everybody keeps talking about the imminent U.S. economic recovery. How it may come about remains a well-kept secret. A main consideration seems to be that recessions in the United States have lasted on average 11 months, and these have already passed if the recession started in March. Further core mantras are that inventory liquidation has probably run its course; that sustained stellar productivity growth is coming to the rescue; and that rising house prices will enable the consumer to maintain his high level of spending.

PRODUCTIVITY GROWTH, THE MAGIC BULLET

It's hard to think of poorer arguments. That's a peculiar New Economy, which for its growth depends heavily on a continuing housing bubble. Most perplexing, though, is the persistent reference to the high rate of productivity growth as the greatest positive feature of this recession. It seems to be the magic bullet that slays all dragons. For years, it was the magic that guaranteed a profit miracle. Now it's the magic that makes for a mild recession and accelerates the economy's rebound. To quote Mr. Greenspan: *"As productivity strengthens, average real incomes could rise, at least partly offsetting losses of purchasing power that stem from diminished levels of employment."*

The apparent underlying assumption is that recorded productivity growth essentially reflects an equal rate of real income growth, benefiting both wages and profits. Referring to Greenspan's remark, *Business Week* wrote: *"Unemployment is devastating to those directly affected, but better productivity will help to boost real pay for the 94% of the labor force that still has jobs."*

Unfortunately and oddly, the stellar productivity figure has no correspondence in the income and profit figures. They tell an entirely different story, showing a performance that is worse than in any prior postwar economic downturn.

PERSONAL INCOMES AND COPORATE PROFITS (IN $ BILLION)

	2000	2001			
	IV	I	II	III	IV
Profits From Current Production	-47.4	-57.8	-30.0	-62.8 *	
Personal Income	138.1	120.6	74.4	57.2	0.2
Wages and Salaries	93.4	76.2	50.4	23.6	-0.8

* annual rates

Source: Commerce Department, Survey of Current Business

To us, this has an obvious explanation: badly flawed productivity measurement. In concept, the measuring of productivity growth is straightforward. It is done by dividing nominal GDP by an estimated price index and a measure of hours worked. The problem is that all three of these variables are subject to considerable measurement error.

It is argued that in the computer age, employees do more unpaid overtime hours at home. As hours worked

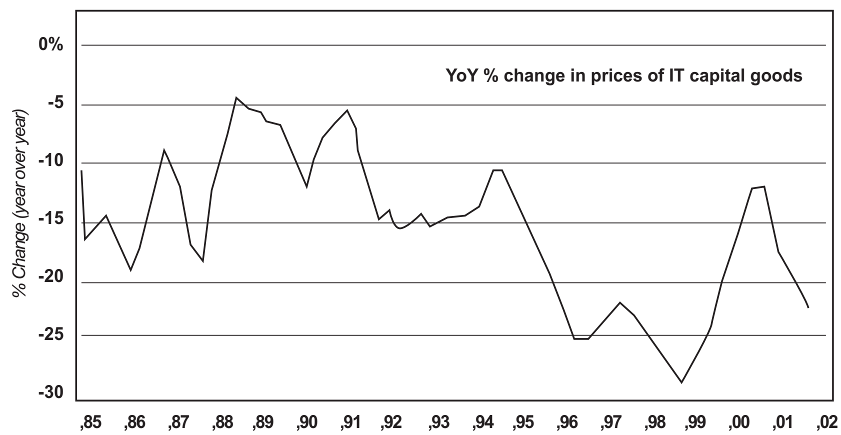
are underestimated, measured productivity growth gets overestimated. We guess this is a proper assumption. But changes in measuring the inflation rate are the obvious, critical problem in measuring U.S. productivity growth.

In the past few years the U.S. government's statisticians have exhibited an unusual eagerness for ever more perfect measurements of the inflation rate. The regular effect of all revisions is a lower inflation rate. Compared to other countries, price indexes in the United States have been significantly deflated in the past few years to reflect quality improvements. This practice became preponderant since early 1997 on recommendations from the Boskin Commission. It had consequences that went far beyond statistics. It justified cuts in Social Security. Above all, though, the resulting lower inflation rates conveyed a dramatically better look of the U.S. economy. As real GDP rose in accordance, this intrinsically gave productivity growth an equal boost.

According to official estimates, the Boskin-related revisions lowered the annual rate of consumer price inflation by 0.7–1 percentage points, implying an equal increase in real GDP and productivity growth. Other estimates put the effect much higher. Not included in these revisions is the hedonic pricing of the computer. While already practiced since the late 1980s, it gained overriding importance in the relevant statistics after 1995 as additions to computer power

In the 1970s, Fed chairman Arthur Burns ordered his economists to invent a more convenient, lower inflation rate. The "core rate" of inflation was the result. According to press reports, the Bureau of Labor Statistics is working on a "chained CPI." It is supposed to capture the reaction of consumers to price changes, called the "substitution bias." It implies, for example, that rising prices of oranges induce the consumer to buy cheaper apples. In the end, the calculation of the CPI becomes so sophisticated that they can pick any number they like, and they like low numbers.

The Accelerated Decline in Prices for Capital Goods Gives GDP Growth a Boost



As to the Boskin recommendations, a new comprehensive study, partly commissioned by the Bureau of Labor, has raised critical questions about the practice of converting quality improvements into price cuts. In the first place, it disputes the central underlying idea that the consumer price index ought to measure consumer satisfaction and the standard of living rather than just actual changes in prices. The study concludes that such an index is inherently too ambitious to be developed in an objective way. One of many objections is that consumers want and need constant improvements just to remain as satisfied as before.

It is our long-held view that this extraordinary zeal of the U.S. government's statisticians for "perfect" measurement of inflation has more than purely statistical reasons. For sure, these people are fully aware that any lowering of the inflation rate has two other effects that are in the focus of the markets. In a single shot, it commensurately raises real GDP and above all related productivity growth, which today's consensus considers the key benchmark of efficiency and prosperity. The point here is that the resulting productivity miracle appears as close to a free lunch in economics as you can get.

And that is really the great problem. The reported productivity miracle of the past few years has immensely buoyed the stock market in expectation of a complementary profit miracle. But the actual, ugly reality in the economy was the most dismal profit performance of all business cycles in the postwar period. To us, this gave early warning to look at the marvelous productivity numbers with a critical eye. Other reasons, however, were

also making us doubtful. Overall, we successively identified three major distortions in the productivity numbers.

These three were: the hedonic pricing of computers; a pronounced shift towards quality-related price cuts; and accelerating depreciation charges owing to sharply higher short-lived investment. Taken together, these three features have added at least 1.5 percentage points to the rate of real GDP and productivity growth since 1995. This assessment led us long ago to the conclusion that the U.S. productivity performance during the past several years was abysmal rather than admirable. The one person who agrees with this view is Professor J. Gordon of Northwestern University.

Properly, there has been a productivity slowdown. It is an appalling, virtually unbelievable statement. But there is strong prima facie evidence in two things: the profits debacle and the capital investment debacle. As mentioned earlier, the rate of net capital investment in the past few years has been at its lowest in the whole postwar period. Not only is net capital investment the single most important source of productivity growth, but in the same vein, it also inherently generates rising demand, rising supply and rising profits. It's the key mover in the economy. Productivity growth without a strong investment component is like a motorcar without a motor.

Pondering these intricacies, it strikes us that GDP in plain money terms, not adjusted for inflation and quality improvements, did not accelerate during the past boom years. It briefly exceeded 6% in 1994 and in 1997. In all other years, it kept below 6%. During 2001, GDP growth in money terms collapsed in a straight line from 4.6% in the first quarter to negative 0.1%, both annualized, in the fourth quarter. For the first time since World War II, nominal GDP growth was below real GDP growth.

CONCLUSIONS:

To summarize once more: The U.S. New Economy was a statistical mirage. With his unfettered monetary expansion, Mr. Greenspan created the greatest economic and financial bubble in history, within which multiple minor and major bubbles developed. Unprecedented excesses were not only in the stock market, they are everywhere in the whole financial system. The other biggest threats are the dollar bubble and consumer spending.

Recent U.S. economic data look better than expected. Still, it was a boost from government spending that moved real GDP growth slightly into positive territory in the fourth quarter 2001. Apart from a possible reversal in the inventory cycle, the conditions for a sustained economic recovery are grossly lacking. Frightening downside risks prevail.

Catch-ups from the lows related to the terrorist attack obscure the trend. Sky-high P/E ratios and the strong dollar certainly reflect strong confidence in the U.S. economy's recovery. But underlying conditions for future business and consumer spending continue to worsen. Creating false confidence is a dangerous policy success.

The major impending risk is that the consumer will pull back as the stock market fails to provide the big wealth effects that everybody is promising him. But further falls in profits guarantee the opposite. Lower consumer spending will finally devastate profits.

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